U.S. Department of the Interior
Office of Inspector General

EVALUATION REPORT

FOLLOWUP OF OFFSHORE MINERALS LEASING ACTIVITIES, MINERALS MANAGEMENT SERVICE

REPORT NO. 98-I-385
MARCH 1998

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United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

EVALUATION REPORT

MAR 27 1998

Memorandum

To: Director, Minerals Management Service

From: Ronald K. Stith
Acting Assistant Inspector General for Audits

Subject: Evaluation Report on Followup of Offshore Minerals Leasing Activities, Minerals Management Service (No. 98-I-385)

INTRODUCTION

This report presents the results of the followup evaluation of our December 1993 audit report "Offshore Minerals Leasing Activities, Minerals Management Service" (No. 94-I-179). The objective of our evaluation was to determine whether the Minerals Management Service had satisfactorily implemented the recommendation in our 1993 report and whether any new recommendations were warranted. During our review, we noted a condition relating to lease rental terms that warranted immediate consideration by Service management. Accordingly, we are also issuing a quick-reaction evaluation report concerning this issue.

BACKGROUND

The Minerals Management Service's mission includes managing the Offshore Minerals Leasing Program under the provisions of the Outer Continental Shelf Lands Act, as amended. To accomplish this part of its mission, the Service prepares oil and gas leasing schedules, holds lease sales on offshore tracts (up to 5,760 acres), and awards leases on offshore Federal lands to the highest qualified bidder. For each lease awarded, the Service receives revenues in the form of bonus bids, rental fees, and royalties if a lessor begins production of oil and gas on the leased tracts. Bonus bids are a one-time cash amount paid per acre to the Service by the highest qualified bidders to obtain leases. Rental fees are annual payments based on a fixed dollar amount per acre, which is established at the time the lease is issued and paid by a lessor to preserve its rights to the lease. Lessors make royalty payments equal to a stated share or percentage of the value of the oil or gas produced on a tract. During calendar years 1996 and 1997, revenues from the sale of Federal offshore oil and gas leases totaled about $8.9 billion, which comprised royalties of about $6.5 billion, bonus bids of $2.1 billion, and rents of $321 million.

SCOPE OF EVALUATION

The scope of our followup evaluation included a review of actions taken by the Service to implement the recommendation made in our December 1993 audit report. As part of the evaluation, we reviewed documents and records pertaining to the Service's offshore oil and gas leasing program for calendar years 1994 through 1997. We also interviewed Service personnel responsible for administering the program. Furthermore, we reviewed the Secretary's Annual Statement and Report to the President and the Congress for fiscal year 1995, which was required by the Federal Managers' Financial Integrity Act, and the Departmental Report on Accountability for fiscal year 1996, which includes information required by the Act, and determined that no material weaknesses were included in the reports which directly related to the objective and scope of our evaluation. Our evaluation was conducted from December 1997 to February 1998 at the Service's Economics Division in Herndon, Virginia.

Our evaluation was made in accordance with the "Quality Standards for Inspections," issued by the President's Council on Integrity and Efficiency. Accordingly, we included such tests of records and other evaluation procedures that were considered necessary under the circumstances to accomplish our stated objective. Because of the limited scope and objective of our review, internal controls were reviewed only to the extent that they related to corrective actions taken on the recommendation in our prior report.

PRIOR AUDIT COVERAGE

In our December 1993 audit report "Offshore Minerals Leasing Activities, Minerals Management Service" (No. 94-I-179), we reported that the Service had established a $25 minimum bonus bid per acre and a $3 rental fee per acre, which were less than the $32.50 bonus bid per acre and the $5.00 rental fee per acre recommended in internal studies performed by the Service.

Specifically, our prior audit found that a March 1992 study conducted by the Service (the most current study available at the time of the prior review) concluded that raising the minimum bonus bid would be in accordance with current market conditions and would increase Federal revenues. In order to indicate the potential for increased bonus bid revenues, we included an estimate in the prior report that the Government would have received up to $25.5 million in additional revenues from 1988 to 1992 had the minimum bonus bid rate been set at $32.50 per acre (the rate recommended in the March 1992 study) at the beginning of 1988.

In addition, our prior audit found that the annual rental fee should be increased because the $3 per acre fee, which was established before 1954, represented only a small percentage of the total costs involved in oil and gas exploration and that therefore an increase in the fee would not impact the Service's ability to lease tracts. In order to indicate the potential for increased rental fee revenues, we included estimates in the prior report that a $5 per acre rental fee (the $3 fee established in 1954 and a $2 increase, the optimal amount recommended by the Service's March 1992 study) for the period of 1988 to 1992 would have

increased rental fee revenues by $120.6 million and that the additional revenues from 1993 to 1996 for leases issued during 1988 to 1992 would have added about $35 million to revenues. In addition, we concluded that higher minimum bonus bids and higher rental fees may encourage companies to begin production or relinquish tracts in a more timely manner, with a potential increase in bonus bid revenues from the resale of relinquished tracts.

RESULTS OF EVALUATION

Our December 1993 audit report (No. 94-I-179) contained the following recommendation:

We recommend that the Director, Minerals Management Service, establish a procedure that requires that the adequacy of the minimum bonus bid and annual rental fee charges be evaluated before each sale and that appropriate adjustments be made if necessary to ensure that the Government receives optimum value for offshore oil and gas leases.

The Acting Director concurred with the recommendation, stating that he believed that "periodic evaluation of the effects of minimum bids and rental rates on Government receipts as well as other leasing objectives is clearly in the public interest." Based on our followup evaluation, we found that the Minerals Management Service had taken quick action to fully implement this recommendation and had increased rental fee rates per acre, which generated an estimated $141 million (Appendix 1) in increased lease revenues between September 1993 and August 1997. Specifically, we found that 11 lease sales were conducted from September 1993 to August 1997, which resulted in the leasing of 4,861 tracts totaling about 26 million acres, and that the Service had evaluated the total effect on revenues of raising the minimum bonus bids and rental fees per acre for each of these sales. Before each lease sale, the Service prepared a Decision Memorandum for the Assistant Secretary for Land and Minerals Management that set forth the terms and conditions for the Final Notice of Sale to be published in the "Federal Register." For example, for Lease Sale No. 168, the Decision Memorandum stated that the Service had considered increases in the minimum bid up to a level of $50 per acre and rental fees up to $10 and concluded that maintaining the minimum bonus bid level at $25 but increasing rental fees would increase Federal revenues and encourage oil and gas exploration and development of the leased tracts.

Based on its analyses, the Service raised the per acre rental fee for leased tracts in water depths of less than 200 meters from $3 to $5, beginning with Sale No. 143 in September 1993, and increased per acre rental fees for tracts of property in water depths of greater than 200 meters from $3 to $7.50, beginning with Sale No. 157 in April 1996. The Service stated that one factor considered in deciding to increase fees for tracts in water depths of 200 meters or more was a November 1995 amendment to the Outer Continental Shelf Lands Act (Title III of Public Law 104-58) which suspends royalties on a specified amount of oil or gas where production is in water exceeding 200 meters. The Service stated that the increased fees for these tracts "would be expected to speed the rates of exploration and development of productive tracts and relinquishment of leased marginal tracts."

The Service said that it expects that leasing activities for tracts in water depths of more than 200 meters will continue to increase for at least the next several years. Because of the

corresponding increase in rental rates for those tracts, the increase in future revenues as a result of the implementation of the prior report's recommendation is expected to continue. We estimated that the leases issued between September 1993 and August 1997 (Lease Sales Nos. 143 through 168) will generate an estimated $194 million in increased lease revenues between 1998 and 2001, as shown in Appendix 2.

Since this report does not contain any recommendations, a response is not required.

We appreciate the assistance of Minerals Management Service personnel during the conduct of our evaluation. We also commend the Director, Minerals Management Service, for the quick implementation of our prior report's recommendation, which has resulted in significant increased revenues and future revenues cited in this report.

cc: Assistant Secretary for Land and Minerals Management

ADDITIONAL RENTAL REVENUES
FOR CALENDAR YEARS 1993 TO 1997
FROM TRACTS LEASED FROM 1993 TO 1997

Sale Number	Acres*	Rate Increased by	1993	1994	1995	1996	1997	Total 1993 through 1997
143	807,882	$2.00	$1,615,764	$1,454,188	$1,308,769	$1,177,892	$1,060,103	$6,616,716
147	1,749,520	2.00		3,499,040	3,149,136	2,834,222	2,550,800	12,033,198
150	1,025,550	2.00		2,051,100	1,845,990	1,661,391	1,495,252	7,053,733
152	2,896,478	2.00			5,792,956	5,213,660	4,692,294	15,698,910
155	1,445,251	2.00			2,890,502	2,601,452	2,341,307	7,833,261
157	2,050,808	2.00				4,101,616	3,691,454	7,793,070
157	2,590,544	4.50				11,657,448	10,491,703	22,149,151
144	105,274	2.00				210,548	189,493	400,041
161	944,299	2.00				1,888,598	1,699,738	3,588,336
161	2,463,117	4.50				11,084,026	9,975,624	21,059,650
166	1,835,567	2.00					3,671,134	3,671,134
166	3,399,393	4.50					15,297,268	15,297,268
149	10,263.5	2.00					20,527	20,527
168	655,720	2.00					1,311,440	1,311,440
168	3,736,808	4.50					16,815,636	16,815,636
Totals	25,716,475							$141,342,071

*Explanatory note: Similar to the Mineral Management Service's in-house studies, we assumed a 10 percent annual lease relinquishment rate. In addition, we assumed that none of the relinquished tracts would be acquired by another company in a subsequent lease sale and that the amount of increased revenues would therefore be greater than the amount estimated. Also, for purposes of calculating total rent, the Service treats each fraction of an acre as a full acre.

POTENTIAL ADDITIONAL RENTAL REVENUES FOR CALENDAR YEARS 1998 TO 2001 FROM TRACTS LEASED FROM 1993 TO 1997

Sale Number	Acres*	Rate Increased by	1998	1999	2000	2001	Total 1998 through 2001
147	1,147,860	2.00	$2,295,720				$2,295,720
150	672,863	2.00	1,345,726				1,345,726
152	2,111,532	2.00	4,223,064	$3,800,757			8,023,821
155	1,053,587.5	2.00	2,107,175	1,896,457			4,003,632
157	1,661,154	2.00	3,322,308	2,990,077	$2,691,069		9,003,454
157	2,098,341	4.50	9,442,532	8,498,278	7,648,450		25,589,260
144	85271.5	2.00	170,543	153,488	138,139		462,170
161	764,882	2.00	1,529,764	1,376,787	1,239,108		4,145,659
161	1,995,124.65	4.50	8,978,061	8,080,254	7,272,228		24,330,543
166	1,652,010	2.00	3,304,020	2,973,618	2,676,256	$2,408,630	11,362,524
166	3,059,453.6	4.50	13,767,541	12,390,786	11,151,707	10,036,536	47,346,570
149	9,237	2.00	18,474	16,627	14,964	13,468	63,533
168	590,148	2.00	1,180,296	1,062,266	956,040	860,436	4,059,038
168	3,363,127	4.50	15,134,072	13,620,664	12,258,597	11,032,737	52,046,070
Totals	20,264,590.7						$194,077,720

*Explanatory note: Similar to the Mineral Management Service's in-house studies, we assumed a 10 percent annual lease relinquishment rate. In addition, we assumed that none of the relinquished tracts would be acquired by another company in a subsequent lease sale and that the amount of increased revenues would therefore be greater than the amount estimated. Also, for purposes of calculating total rent, the Service treats each fraction of an acre as a full acre.

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